

## Internal Revenue Service

Number: **201716044**

Release Date: 4/21/2017

Index Number: 856.04-00

## Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

ID No.

Telephone Number:

Refer Reply To:

CC:FIP:B02

PLR-138800-16

Date:

January 05, 2017

### Legend

Taxpayer =

Distributing =

Bankruptcy Court =

Date 1 =

Date 2 =

U =

V =

W =

X =

Y =

Z =

State A =

Leased Property =

Dear \_\_\_\_\_ :

This ruling responds to a letter dated March 19, 2015 and supplemental submissions submitted on behalf of Taxpayer. Taxpayer requests that for purposes of applying § 1.856-4(b)(3) of the Income Tax Regulations (the "Regulations"), (i) only a proportionate amount of the rent received by Controlled (defined below) from Distributing, which will depend in part on rent from a sub-sublease that is based on income or profits of Sub-Subtenant (defined below), will be treated as other than "rents from real property"; and (ii) for purposes of computing this proportionate amount under § 1.856-4(b)(6)(ii)(B), the numerator of the fraction equals all rent or other amount received by Subtenant (defined below) pursuant to the sub-sublease between Subtenant and Sub-Subtenant, and the denominator equals all rent or other amount received by Distributing under the Sublease (defined below).

### **FACTS**

Taxpayer is a State A corporation. Taxpayer represents that, pursuant to a bankruptcy plan to be approved by the Bankruptcy Court, it will engage in a reorganization whereby one of its subsidiaries, Distributing, will restructure its business (the "Proposed Transaction"). As part of the Proposed Transaction, Distributing has formed a wholly owned subsidiary, a State A limited liability company ("Controlled"). Distributing (or its subsidiaries that are treated as disregarded entities for federal income tax purposes) will contribute certain assets, including Leased Property, to Controlled (the "Contribution"). Controlled will then contribute those assets (including the Leased Property) to certain subsidiaries that are treated as disregarded entities for federal income tax purposes. In consideration for the Contribution, Distributing will receive, inter alia, all common and preferred stock of Controlled. Distributing will then distribute assets, including the common and preferred stock of Controlled, to creditors of Distributing (the "Distribution") in satisfaction of their claims against Distributing.

Controlled intends to elect to be treated as a real estate investment trust (a "REIT") under §§ 856-860 of the Internal Revenue Code (the "Code") effective for either the taxable year beginning the day after the Distribution and ending on December 31 of that calendar year or the calendar year following the year in which the Distribution occurs.

Controlled, through certain lower-tier entities, will lease Leased Property to Distributing under a lease with an initial U-year term and V W-year renewal terms (the "Prime Lease"). Distributing will pay fixed rents for the first X years, and then in subsequent years will pay rent that is based on a fixed amount and a percentage of Distributing's gross revenues subject to certain adjustments.

The Prime Lease will be subject to an existing lease to an unrelated third party ("Subtenant") executed on Date 1 (the "Sublease"). The Sublease terminates on Date 2, and vests Subtenant with Y Z-year extension option. Subtenant has subleased the property it leases from Distributing to various other unrelated third parties that will be sub-subtenants of Distributing after completion of the Proposed Transaction. One such sub-subtenant ("Sub-Subtenant") pays rent that is based on Sub-Subtenant's net income from the property it leases from Subtenant. Taxpayer represents that this profit-based sub-sublease is a preexisting arrangement entered into for business reasons independent of tax considerations. Taxpayer also represents that Controlled would not receive a greater amount of income that qualifies as rents from real property pursuant to the formula in § 1.856-4(b)(6)(ii)(B) if Distributing were to have directly entered into the same lease with Sub-Subtenant.

### **LAW AND ANALYSIS**

Section 856(c)(2) of the Code provides that at least 95 percent of a REIT's gross income must be derived from, among other sources, "rents from real property." In addition, § 856(c)(3) provides that at least 75 percent of a REIT's gross income must be derived from, among other sources, "rents from real property."

Section 856(d)(1) provides that "rents from real property" includes (subject to exclusions provided in § 856(d)(2)): (A) rents from interests in real property; (B) charges for services customarily furnished or rendered in connection with the rental of real property, whether or not such charges are separately stated; and (C) rent attributable to personal property leased under, or in connection with, a lease of real property, but only if the rent attributable to the personal property for the taxable year does not exceed 15 percent of the total rent for the tax year attributable to both the real and personal property leased under, or in connection with, the lease.

Section 856(d)(2)(A) (the "exclusionary rule") generally provides that, except as provided in §§ 856(d)(4) and (6), rents from real property does not include any amount received or accrued, directly or indirectly, with respect to any real or personal property, if the determination of such amount depends in whole or in part on the income or profits derived by any person from such property (except that any amount so received or accrued shall not be excluded from the term rents from real property solely by reason of being based on a fixed percentage or percentages of receipts or sales).

Section 856(d)(4) provides that if a REIT receives or accrues, with respect to real or personal property, any amount that would be excluded from the term rents from real property solely because the tenant of the REIT receives or accrues, directly or indirectly, from subtenants any amount the determination of which depends in whole or in part on the income or profits derived by any person from such property, only a proportionate part (determined pursuant to regulations prescribed by the Secretary) of the amount

received or accrued by the REIT from that tenant will be excluded from the term rents from real property (the "proportional exclusion rule").

Section 1.856-4(a) of the Regulations defines the term rents from real property generally as the gross amounts received for the use of, or the right to use, real property of the REIT. Section 1.856-4(b)(3) provides in relevant part that, except as provided in § 1.856-4(b)(6)(ii), no amount received or accrued, directly or indirectly, with respect to any real property (or personal property leased under, or in connection with, real property) qualifies as rents from real property if the determination of the amount depends in whole or in part on the income or profits derived by any person from the property. However, any amount so accrued or received shall not be excluded from the term rents from real property solely by reason of being based on a fixed percentage or percentages of receipts or sales (whether or not receipts or sales are adjusted for returned merchandise, or Federal, State, or local sales taxes). For example, rents from real property includes rents under a lease that provides for differing percentages of receipts or sales from different departments or from separate floors of a retail store so long as each percentage is fixed at the time of entering into the lease, and a change in such percentage is not renegotiated during the term of the lease (including any renewal periods of the lease) in a manner that has the effect of basing the rent on income or profits. In addition, if in accordance with the terms of an agreement an amount received or accrued as rent for the taxable year includes both a fixed rental and a percentage of all or a portion of the lessee's income or profits, neither the fixed rental nor the additional amount will qualify as rents from real property. In any case, an amount will not qualify as rents from real property if, considering the lease and all the surrounding circumstances, the arrangement does not conform with normal business practice but is in reality used as a means of basing the rent on income or profits.

Section 1.856-4(b)(6)(i) states that except as provided in § 1.856-4(b)(6)(ii), if a REIT leases real property to a tenant under terms other than solely on a fixed sum rental (for example, a percentage of the tenant's gross receipts), and the tenant subleases all or a part of such property under an agreement that provides for a rental based in whole or in part on the income or profits of the sublessee, the entire amount of the rent received by the trust from the prime tenant with respect to such property is disqualified as rents from real property.

Section 1.856-4(b)(6)(ii) states that for taxable years beginning after October 4, 1976, the proportional exclusion rule provides an exception to the general rule that amounts received or accrued, directly or indirectly, by a REIT do not qualify as rents from real property if the determination of the amount depends in whole or in part on the income or profits derived by any person from the property. This exception applies when the REIT rents property to a tenant (the prime tenant) for a rental that is based, in whole or in part, on a fixed percentage or percentages of the receipts or sales of the prime tenant, and the rent that the REIT receives or accrues from the prime tenant pursuant to the lease would not qualify as rents from real property solely because the prime tenant

receives or accrues from subtenants (including concessionaires) rents or other amounts based on the income or profits derived by a person from the property. Under the exception, only a proportionate part of the rent received or accrued by the REIT does not qualify as rents from real property. The proportionate part of the rent received or accrued by the REIT that is non-qualified is the lesser of the following two amounts:

(A) The rent received or accrued by the REIT from the prime tenant pursuant to the lease, that is based on a fixed percentage or percentages of receipts or sales, or

(B) The product determined by multiplying the total rent which the REIT receives or accrues from the prime tenant pursuant to the lease by a fraction, the numerator of which is the rent or other amount received by the prime tenant that is based, in whole or in part, on the income or profits derived by any person from the property, and the denominator of which is the total rent or other amount received by the prime tenant from the property. For example, assume that a real estate investment trust owns land underlying a shopping center. The trust rents the land to the owner of the shopping center for an annual rent of \$10x plus 2 percent of the gross receipts which the prime tenant receives from subtenants who lease space in the shopping center. Assume further that, for the year in question, the prime tenant derives total rent from the shopping center of \$100x and, of that amount, \$25x is received from subtenants whose rent is based, in whole or in part, on the income or profits derived from the property. Accordingly, the trust will receive a total rent of \$12x, of which \$2x is based on a percentage of the gross receipts of the prime tenant. The portion of the rent which is disqualified is the lesser of \$2x (the rent received by the trust which is based on a percentage of gross receipts), or \$3x, (\$12x multiplied by \$25x/\$100x). Accordingly, \$10x of the rent received by the trust qualifies as "rents from real property" and \$2x does not qualify.

The legislative history indicates that the proportional exclusion rule is necessary because full exclusion of rents may be an unduly harsh result to a REIT whose prime tenant has entered into subleases over which the REIT may not have control. See JOINT COMM. ON INT. REV. TAX., 94TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 456-57 (1976) ("[I]t is often very difficult for a REIT to control the terms of leases which the prime tenant enters into with its subtenants . . . the Act contains an amendment under which only a proportionate part of the rent . . . is nonqualifying income . . .").

The equation in § 1.856-4(b)(6)(ii)(B) consists of three components: (1) the total rents received or accrued from the prime tenant; (2) the rent or other amount received by the prime tenant that is based in whole or in part on any person's income or profits from the property (the "numerator"); and (3) the total rent or other amount received by the prime tenant for the property (the "denominator").

The exclusionary rule and § 1.856-4(b)(3) generally prohibit the apportionment of an income stream with respect to any lease for real property into qualifying rents from real property and disqualified profit-based rents. However, when an income stream from a prime lease of real property depends in whole or in part on income streams from the subleasing of the real property, §§ 856(d)(4) and 1.856-4(b)(6)(ii) direct that the exclusionary rule be applied to the prime lease income stream on a sublease-by-sublease basis. Congress enacted the exclusionary rule to prevent the total disqualification of a REIT's income from real property due to subleases, over which the REIT may have no control, entered into between a prime tenant and a subtenant. The relationship between a subtenant and a sub-subtenant is more attenuated from the REIT than the relationship between the prime tenant and a subtenant and, therefore, it is also appropriate to apply the proportional exclusion rule in situations in which rent is based in whole or in part on the income or profits of a sub-subtenant.

Taxpayer has represented that neither Taxpayer, Distributing nor Controlled are related to either Subtenant or Sub-Subtenant. Taxpayer has also represented that Controlled would not receive a greater amount of income that qualifies as rents from real property pursuant to the formula in § 1.856-4(b)(6)(ii)(B), as described above, if Distributing were to have directly entered into the same lease with Sub-Subtenant. Accordingly, when Controlled receives or accrues an amount from Distributing that depends in part on the income or profits of Sub-Subtenant, the numerator of that formula is the rent or other amount received by Subtenant from Sub-Subtenant. The denominator of that formula equals any rent or other amount received by Distributing from the Sublease.

### **CONCLUSION**

Based on the facts presented and representations made by Taxpayer, we conclude that for purposes of applying § 1.856-4(b)(3), (i) only a proportionate amount of the rent received by Controlled from Distributing, which will depend in part on rent from a sub-sublease that is based on income or profits of the Sub-Subtenant, will be treated as other than "rents from real property"; and (ii) for purposes of computing this proportionate amount under § 1.856-4(b)(6)(ii)(B), the numerator of the fraction equals all rent or other amounts received by Subtenant pursuant to the Sub-Sublease, and the denominator equals all rent or other amounts received by Distributing under the Sublease.

This ruling's application is limited to the facts, representations, Code sections, and regulations cited herein. Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no opinion is expressed concerning whether Controlled otherwise will qualify as a REIT under subchapter M, part II of Chapter 1 of the Code. No opinion is expressed on whether the sub-sublease

arrangement conforms with normal business practices, or is a means of basing rents from real property on the income or profits of any person from Leased Property.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Julanne Allen  
Julanne Allen  
Assistant to Branch Chief, Branch 3  
(Financial Institutions & Products)